# AOR Update: Bank Crisis Recalibrates the Fed's Path

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## Key Takeaways

- The evolution of risks to financial stability will be a key factor into the Fed's near-term thinking above and beyond their goal of achieving the dual mandate of price stability and maximum employment.
- We view a 25 basis point rate hike as the most likely outcome at the next FOMC meeting on March 22. Given the fluidity of the situation, a pause is also possible with rate cuts and a 50 bps hike even more remote at this juncture.
- Irrespective of what the Fed ultimately decides, it seems probable that lending standards will tighten further meaning less access to credit for borrowers and a higher cost of capital, resulting in slower economic growth. This reinforces our longstanding view that a U.S. recession is on the horizon.

## Regulation, Monetary Policy Can Intersect When Financial Stability at Risk

The first two months of the year have been anything but boring when it comes to the prevailing economic narrative. Coming into 2023, consensus was convinced a recession was imminent. By mid/late January, a soft landing became the primary storyline following cooler inflation and wage prints, with several FOMC members reinforcing this possibility. Given firming inflation data and an economy that appears to be reaccelerating, today the main narrative centers around whether the Federal Reserve is (once again) behind the curve. In a more "normal" environment, one could shrug off this potential uptick given one of the fastest starts to a hiking cycle in modern history. However, this cycle has been anything but normal, with the pandemic altering many "typical" business cycle dynamics over the past three years.

Sunday night the Federal Reserve, U.S. Treasury and FDIC took extraordinary steps in an effort to head off a banking panic. Regulators are attempting to restore confidence by providing liquidity on favorable terms to assist banks in meeting deposit withdrawals under a new program called the Bank Term Funding Program (BTFP) and improving the terms on which banks can borrow at the discount window – the lender of last resort. Only time will tell if these steps prevent further bank runs, but regulators taking strong and decisive actions early is a positive development in our view.

What happens in the coming days and weeks will drive future actions both from a regulatory and monetary policy perspective. The Fed typically likes to think of regulation and monetary policy as separate and distinct, however they can intersect when financial stability comes into question. The degree to which there are perceived risks to financial stability will factor into the Fed's near-term thinking above and beyond price stability and maximum employment. With this in mind, we believe there are four potential outcomes for the Fed at the upcoming Federal Open Market Committee (FOMC) meeting on March 22:

1. **Emergency Rate Cuts**

   If risks to financial stability accelerate further, this may trump the discomfort from stubbornly high inflation. As we saw in the United Kingdom last fall with the LDI crisis, market disorder that risks financial stability can lead to the creation of emergency programs in a "break the glass" situation. The current crisis could rapidly spiral into such a scenario due to additional bank failures or the disorderly behavior of financial markets. If either event transpires, a rescue package accompanied by emergency rate cuts may be necessary. The Fed tends to think that the cost of doing too much is far less than the cost of doing too little – an important lesson from the Global Financial Crisis that was reinforced during the COVID-19 pandemic. These actions could occur before the FOMC meeting next week, as there is little upside to waiting. Given the preemptive actions taken over the weekend and the fact that recent bank failures seem more idiosyncratic than systemic given their outsized exposure to the troubled crypto and tech/VC spaces, the chances of this path playing out have diminished.

2. **Temporary Pause**

   If the steps taken so far are successful in stemming the current crisis, but the Fed perceives the underlying risks behind recent events to be systemic in nature, then a temporary pause at next Wednesday's meeting could occur. Two years ago, the Fed published a paper introducing the concept of a financial (in)stability real interest rate, known as r**. Simply put, this concept suggests there is some level of interest rates that can trigger financial instability events – a point where the Fed has raised interest rates enough to break things. If the Fed thinks this point has been reached (or they are very close to it), then pausing interest rate hikes may be the logical conclusion until the dust settles. At this juncture, the chances of this playing out are higher than an emergency cut given the BTFP was fairly targeted in nature, hinting that the Fed may view recent events as more idiosyncratic than systemic. Even if r** remains far from the current level of interest rates, it appears likely credit will further contract in the coming months as banks focus on survival rather than loan growth. This could lead the Fed to conclude that a pause is the best outcome given an expectation of slower growth (and in turn inflation) in the near term regardless of their views on r**. We view a temporary pause in rate hikes as the second most likely outcome.

3. **25 basis point Hike**

   If the Fed views recent bank volatility as the confluence of a series of unfortunate events and decisions – complex systems fail in complex ways – and believes its actions have staved off further contagion, the stage may be set for them to move forward with an interest rate hike next week. The lack of widespread deposit outflows in the coming days is one thing to watch for when evaluating the chances of this path playing out, as this could indicate reduced systemic (and thus financial stability) risk. This morning's inflation release shows a clear need to forge ahead in the battle against elevated inflation. However, the lack of a blowout suggests that a reacceleration in the pace of rate hikes may not be needed at this juncture given the uncertain backdrop. Specifically, the Fed could elect for a 25 bps hike out of an abundance of caution if financial stability risks have meaningfully receded but there are lingering worries from recent strong economic data in the minds of FOMC officials. We view this path as the most likely outcome as the Fed will not want to stand pat in the face of a tight labor market and still too-high inflation, especially if financial stability risks are moving rapidly into the rearview mirror.

4. **50 basis point Hike**

   Prior to the current banking crisis breaking out, Fed Chair Jerome Powell appeared to be putting a 50 bps hike on the table during his semi-annual monetary policy report and associated Congressional testimony last week. This led to Fed Fund futures pricing a 70% chance of a 50 bps hike by last Wednesday's close, just before Silicon Valley Bank lit the spark for a crisis by announcing plans to raise capital, having liquidated their available-for-sale bond portfolio at a substantial loss. In order to land on a 50 bps hike, the Fed will also need to conclude that financial stability risks have fully receded given continued strong inflation and jobs data. It appears highly unlikely that the Fed will be able to confidently make this determination in one week's time. Further, the lack of an outsized beat in this morning's CPI release reduces the urgency to go 50 bps, making this option a similarly low probability to emergency cuts in our view.

When evaluating the possible paths for U.S. monetary policy, it's important to note that the Fed's financial crisis playbook has historically included rate cuts as one tool to help restore confidence and orderly market function. Stubbornly high inflation and an extremely tight labor market, however, may be changing the calculus currently which is why we believe that a 25 bps hike or even a pause should be interpreted as moderately hawkish outcomes that reflect a Fed still fully committed to achieving its price stability goal.

Financial participants have woken up to this possibility with Fed Fund futures currently pricing an 80% chance of a 25 bps rate hike next week, up from 55% last night. We believe the chances of a 25 bps rate hike may drift higher in the coming days if Monday's calm extends deeper into the week. While the fluid and rapidly evolving situation makes handicapping the likelihood of each path particularly challenging and subject to change as new information emerges, we find this framework helpful as we assess new developments, allowing us to update our views as needed.

Irrespective of what the Fed ultimately decides, it seems probable that lending standards will tighten further meaning less access to credit for borrowers and a higher cost of capital. When banks come under pressure, they tend to be more conservate in making new loans. To be clear, loan officers had tightened standards considerably over the past several months. In fact, lending standards were already at extraordinarily tight levels consistent with past recessions before the current crisis broke out. The events of the past few days should further exacerbate the situation, resulting in slower economic growth as both consumers and corporations are forced to forgo or scale back plans and new activity. While the Fed was certainly not trying to spark a banking crisis, tighter lending standards is one development the central bank hoped to achieve as it rapidly hiked interest rates over the last year.

## Recession Risks Amplified

Our view for the last nine months has been that a policy-error induced recession was the most likely outcome of the Fed's inflation fight. We did not anticipate bank failures, but recent events lay bare the transmission mechanism from monetary policy into the economy which occurs with notoriously long and unknown lags. Just two months ago the notion of an economic "no landing" characterised by an ongoing boom was taking hold. In the last week, however, three banks have failed which is typically more indicative of a bust. We believe the events of the last few days have amplified recession risk over the coming year, and we continue to advocate positioning for elevated volatility with a tilt toward defensive, high-quality equities.

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